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ALTERNATIVES FOR TAX RESTRUCTURE IN TENNESSEE

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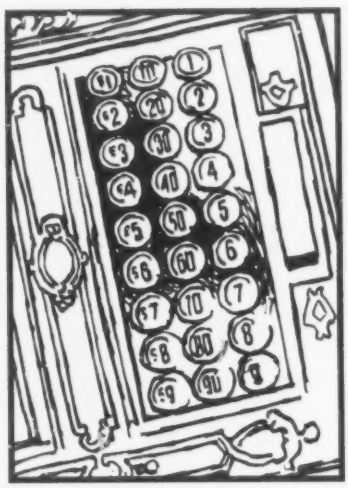

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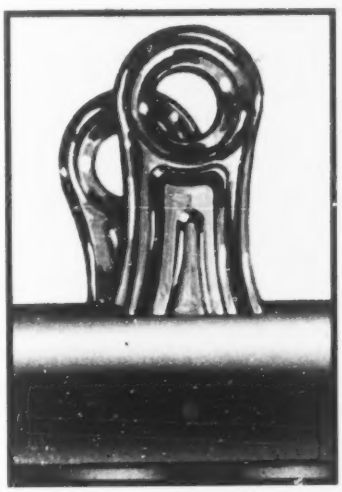

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RESTRUCTURING BUSINESS TAXES IN TENNESSEE

Kenneth E. Quindry *Research Professor Emeritus, UTK*
and
John L. Parish, *Chairman of the Board and CEO, Lannom Manufacturing Co., Inc.*

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Consulting Editor's Comments

Tax reform is currently a major concern of government at every level, particularly among the states. Mostly in response to the effects of recent business cycles, tax reform commissions have been created in twelve states to study and make recommendations on the best tax structures. Since states have different economic patterns, citizen expectations, and historical development, it is necessary for them to determine independently what tax structures best suit their needs.

The Tennessee state revenue structure has major flaws which require reform if the service requirements of the citizens are to be met adequately. In response to these perceived flaws, groups from both the executive and legislative branches have been meeting regularly for more than a year to consider the best alternatives. Any recommendations they choose to make are expected sometime this winter.

The importance and timeliness of the structure alternatives make it an appropriate subject for an entire issue of the **Survey of Business**. The first article, by William F. Fox and Kenneth E. Quindry, is an overview of the current tax structure, reasons for reform, and alternatives for reform. Dr. Quindry, a long-time student of the Tennessee tax structure, was staff director of the 1974 Tennessee Tax Reform Commission.

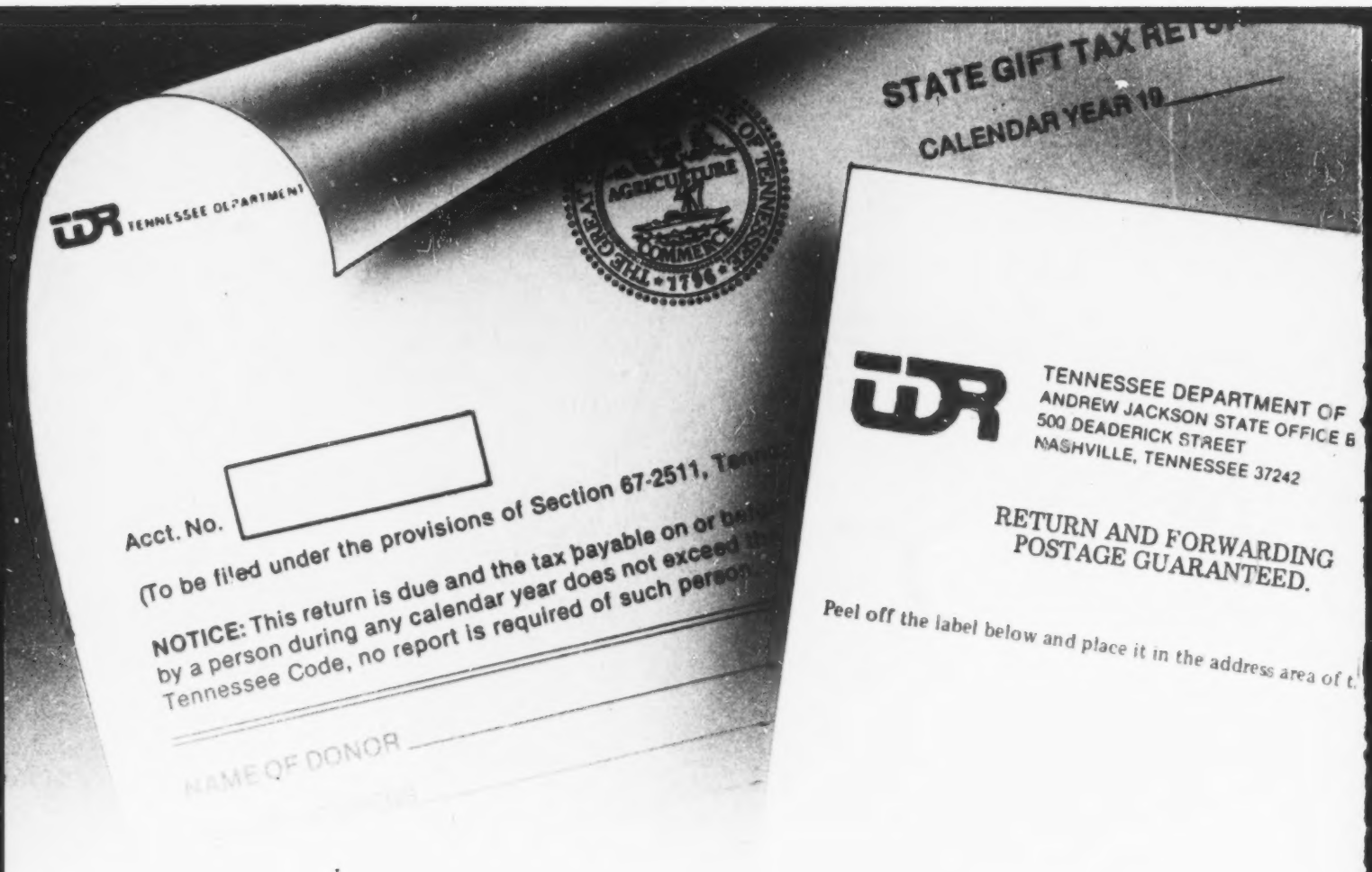
The second article, authored by Representative John T. Bragg and W. Jeff Reynolds, identifies three basic problems with the current Tennessee tax structure: it is not fair, it is not good for business, and it does not work well for government. Representative Bragg is chairman of the Special Joint Legislative Task Force on Taxation, and Mr. Reynolds is staff assistant to the Tennessee Comptroller and has been serving as a staff member to the Task Force.

Stanley M. Chervin, Research Director in the Tennessee Department of Revenue, authored the third article on "Tax Issues and Tax Alternatives." Dr. Chervin has been directly involved as a staff member on the tax reform committees.

Kenneth E. Quindry and John L. Parish provided the fourth article on restructuring business taxes. They conclude that the optimal approach to taxing business in Tennessee would be through a single business tax. As a business leader and former Commissioner in the Department of Economic and Community Development, Mr. Parish has a keen sense of what tax structure would best serve this state.

William F. Fox,
*Consulting Editor**

**William F. Fox is Associate Professor of Economics at The University of Tennessee, Knoxville, Associate Director of the Center for Business and Economic Research, and Director of the Tennessee Econometric Modelling Project.*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Tax Reform In Tennessee: Needs and Options

William F. Fox and Kenneth E. Quindry

Recently, tax reform has been the subject of discussion in Tennessee, because two groups of policy makers are now intently considering the issue. A legislative task force comprised of seven members of the House, seven members of the Senate, the Lieutenant Governor, and the Speaker of the House has been actively examining the need for reform, and, at the same time, a cabinet-level committee has been undertaking a similar exercise for the executive branch. Both groups are expected to reveal their recommendations in early 1985.

This article describes previous efforts to reform taxes, the current Tennessee fiscal condition, the reasons why tax reform may be desirable, and the potential approaches to tax reform.

HISTORY OF TAX REFORM

Current studies of tax reform represent the continuation of a long line of such efforts dating from at least 1915, with 22 major tax studies conducted from 1915 to 1982. However, while they were viewed as comprehensive, most studies in the past concluded with limited recommendations regarding the taxing of privileges, property, and sales. The Hall income tax, the state and local general sales taxes, the local business taxes, and classification of property for taxation are examples of major recommendations of study groups that were eventually enacted by the legislature.

The Legislative Council (1953) and the Fiscal Review Committee (FRC-1957), established as permanent research agencies, were given the responsibility of studying state-local tax policies. The council has now been replaced by the Tennessee Advisory Commission on Intergovernmental Relations (TACIR). Both the FRC and the TACIR continually focus on specific taxes and current fiscal issues as directed by the legislature.

Early on, Tennesseans concluded that income taxation was the domain of the federal government: hence, the state passed the sales tax of 1946. It was not until 1961 that a Legislative Council Committee report recognized the potential need for a personal income tax to be instituted at some later but indefinite time. In 1972-74 the Tax Modernization and Reform Commission

recommended a low flat rate personal income tax. The enabling statute and the report itself reflected the growing concern over continuing personal tax inequities and the need to improve the business climate to create more jobs and income. A tax system based on consumption and property was regarded as inelastic and regressive as well as inimical to balanced economic development.

A better business climate, including relief from the complex business tax structure, was the primary objective of a 1977 study commissioned by the Department of Economic and Community Development and conducted by U.T. personnel. This study proposed a simple comprehensive business tax in lieu of a series of gross receipts, income, and privilege taxes. The business tax would broaden the concept of what constitutes a business for business tax purposes (especially to professions), reduce the distinction between incorporated and unincorporated businesses for tax purposes, and broaden the tax base by removing most exemptions and deductions.

William F. Fox is the Associate Director for the Center for Business and Economic Research and Associate Professor of Economics at The University of Tennessee, Knoxville, College of Business Administration. Director of the Tennessee Econometric Modelling Project and a consultant to various state agencies, he has published widely in public finance and regional economics.

Kenneth E. Quindry is Research Professor Emeritus at the Center for Business and Economic Research, College of Business Administration, The University of Tennessee, Knoxville. Former chairman of the Research Section of the National Association of Tax Administration, he also served on the Association's Committee for Intergovernmental Fiscal Relations and has assisted the legislative committee charged with drafting the legislation implementing the Tennessee Spending Limitation.

TENNESSEE FISCAL CONDITION

Expenditures

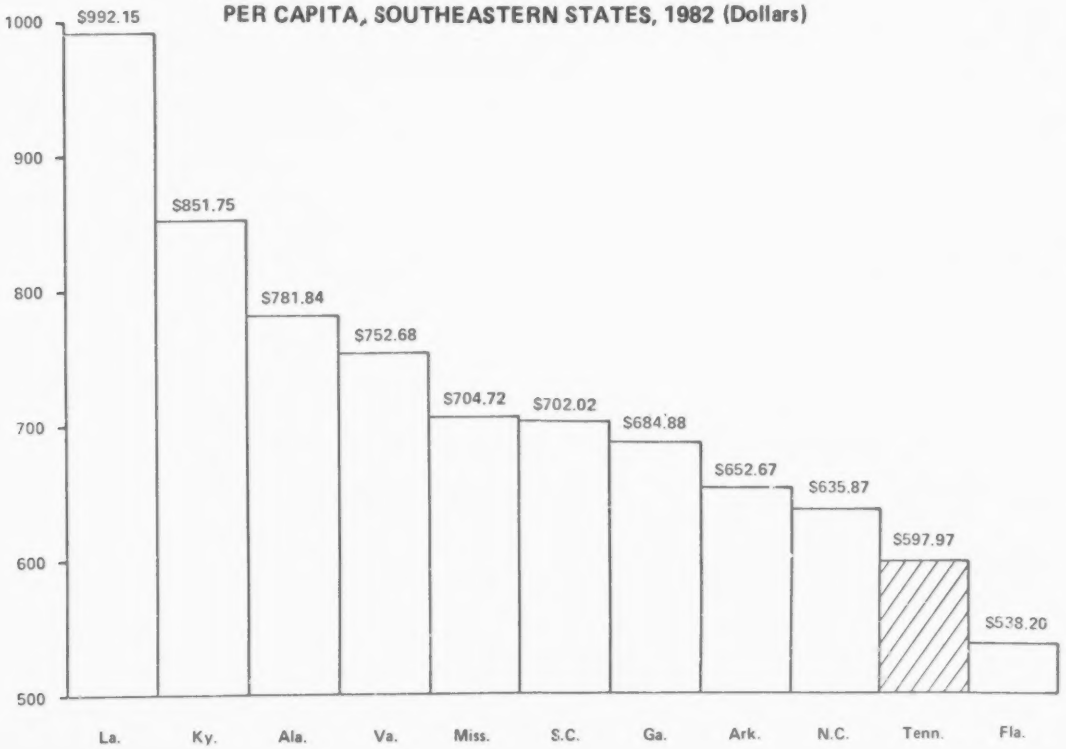
Although determining the desired size of government is conceptually complex, one approach is to compare per-capita expenditures with those of other states. The Tennessee state government public sector is small when measured by expenditures per capita. Nine southeastern states spend more per capita than Tennessee, and only Florida ranks lower. State expenditures for education, parks, highways, corrections, and other public services were $597.97 per capita in Tennessee in 1982 (see Figure 1).

Comparisons based solely on state expenditures can be misleading, however, because services provided by states in some places are provided by local governments in others. Nonetheless, the picture remains the same, since Tennessee still ranks tenth in per-capita spending when all state and local government expenditures are added together. However, in this case, Arkansas is lowest on the list, and Florida moves to third.

Education expenditures comprise 52 percent of Tennessee state government expenditures (see Figure 2), up from 43 percent twenty years ago.

FIGURE 1

STATE GOVERNMENT DIRECT GENERAL EXPENDITURE PER CAPITA, SOUTHEASTERN STATES, 1982 (Dollars)



In 1984-85, transportation represents 10 cents of every dollar spent compared with 16 cents of every dollar in 1963-64. Counties and cities receive 9 cents in shared taxes today versus 13 cents twenty years ago. The remainder is spent on a wide assortment of activities, including corrections, government operations, recreation and regulation.

Tax Structure

Tennessee state government revenues raised from own sources (excluding federal grants) were a smaller percentage of personal income in 1983 than in 1970 (see Figure 3). The pattern of the tax burden, measured by revenues relative to personal income, has been volatile in the interim, but the reasons are straightforward. Tax rate increases in 1971 (sales and corporate excise), 1976 (sales), and 1981 (gasoline) caused increases in the tax burden. During the other years the tax burden declined because tax revenues grew slower than income.

The Tennessee tax structure is dominated by consumption-related taxes (see Figure 4). The general sales tax provided 52.4 percent of tax collections in 1983, and this percentage will rise in 1984 because of the sales tax rate increase. Selective sales taxes, including those on motor fuels, tobacco, and alcohol, provide another 23.5 percent of tax collections, so that consumption-related taxes are responsible for 75.9 percent of collections.

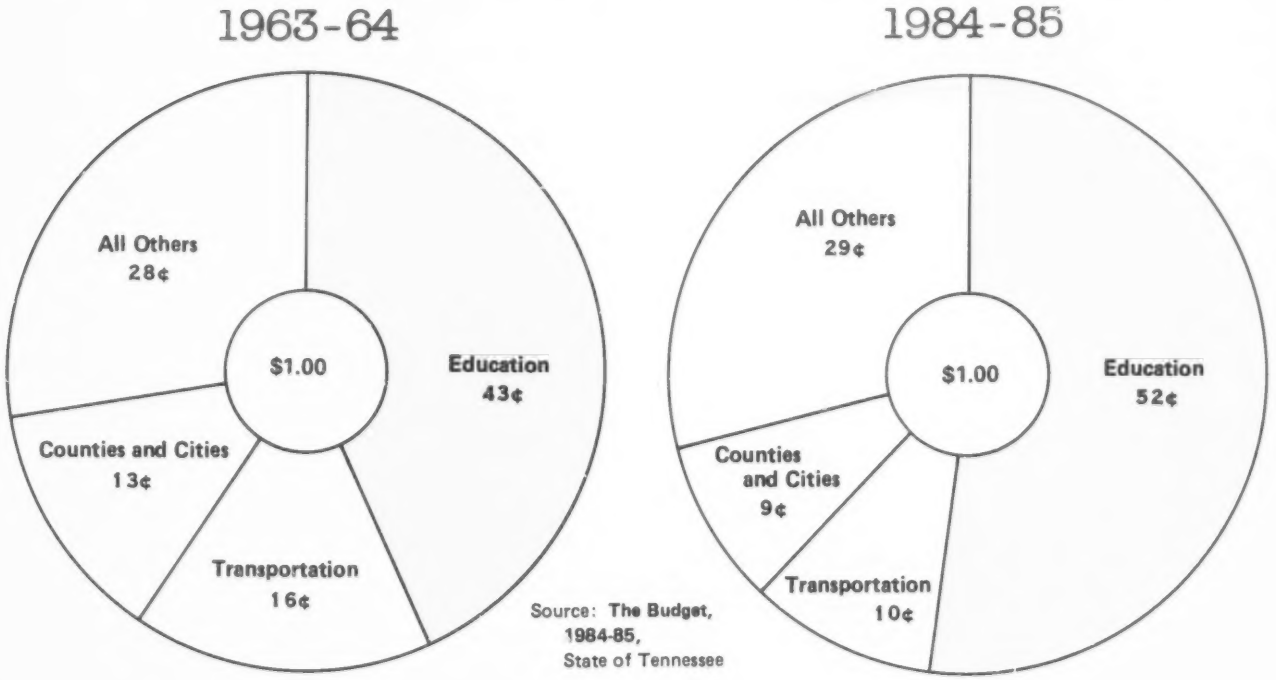
Tennessee differs markedly from the average state in its reliance on consumption taxes. The average state generates less than one-third of its taxes from a general sales tax and about one-sixth of its revenues from selective sales taxes. Overall, the average state obtains only 48.9 percent of its tax dollar from consumption-based taxes. Relative reliance on the corporate income tax is also heavier in Tennessee.

The average state has a reduced reliance on consumption-based taxes because it balances the structure with an income tax. Nationwide, 29.1 percent of state tax revenues arise from income taxes, and Tennessee generates only 2.3 percent of revenues from the Hall income tax on dividends and interest.

The Tennessee tax structure is also different from other southeastern states (see Figure 5). Except for Florida, all states generate a greater share of revenues from an income tax than Tennessee. States which choose limited use of an income tax generally have other significant bases to tax. The ability to tax tourists in Florida makes the sales tax an appropriate collection device. Louisiana, the other southeastern state generating a small percentage of revenues from an income tax, is able to raise large revenues from oil-related sources.

In 1983, Florida was the only state to raise a higher percentage of revenues from the general sales tax than Tennessee, although the 1984 Tennessee sales tax rate increase probably places Tennessee ahead of Florida in reliance on the sales tax. Also, Tennessee is the

Figure 2
Where Your Tax Dollar Goes



Source: **The Budget, 1984-85,** State of Tennessee

heaviest user of consumption-based taxes when the general and selective sales taxes are added together.

Summary

Tennessee is a small government state when compared with other southeastern states. More than one-half of the state's government expenditures go for education, representing a much greater share than was appropriated 20 years ago. By comparison with either the United States or the Southeast, Tennessee is a very heavy user of consumption-based taxes and a very light user of income-based taxes.

REASONS FOR TAX REFORM

The reasons that tax reform is necessary in Tennessee can be grouped into five classifications – simplification; equity; unstable revenue growth; economic development; and revenue generation. Details for each are enumerated in the following sections.

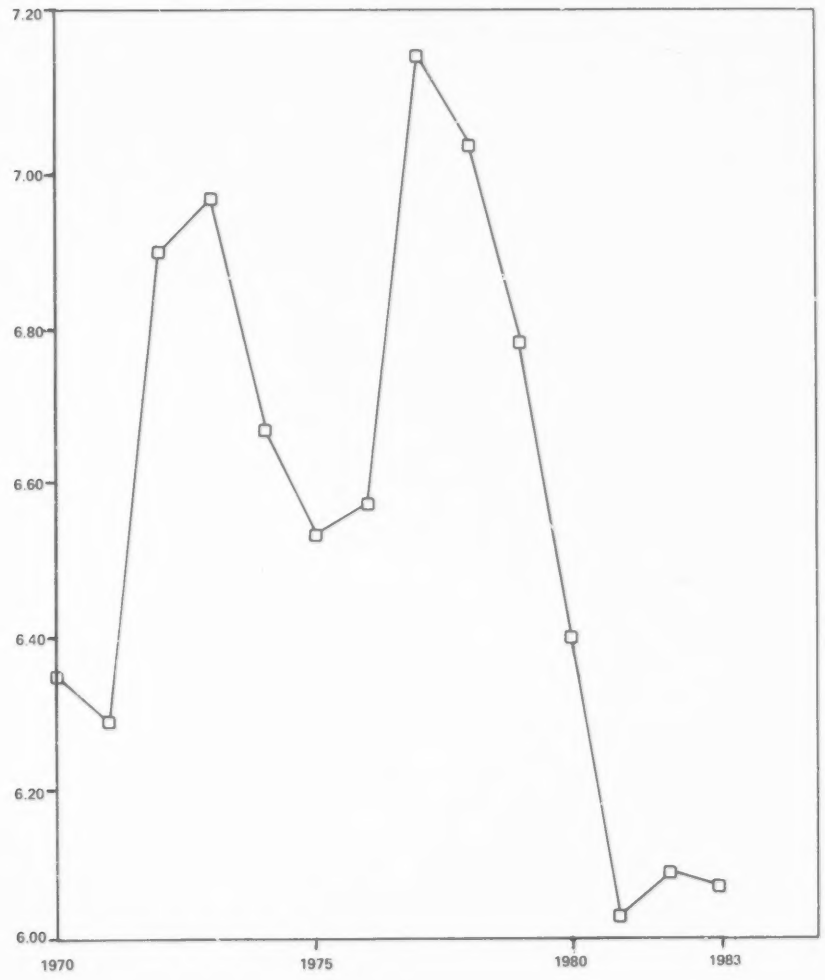
Simplification

Simplification of the tax system is frequently supported as the most important need for business tax reform. The numerous levies are regarded as burdensome to comply with, particularly for small businesses. An individual business firm could pay corporate excise, corporate franchise, gross receipts, sales, local business, personal and real property taxes and could be responsible for collecting the sales tax on its retail sales. Compliance with these taxes can be expensive for the firms, and administrative costs are high for state government because of the proliferation of small taxes. Replacement of the many small taxes with a few productive taxes is the solution generally advocated.

The degree of simplicity desired for the tax system must be balanced with other objectives. A less complex system, for example, is more difficult to tune to the needs and concerns of each business type. Thus, a certain degree of complexity is necessary to maintain a fair system.

FIGURE 3

TENNESSEE STATE GOVERNMENT OWN SOURCE REVENUE AS A PERCENT OF TOTAL PERSONAL INCOME 1970-1983



Equity

Equity is a concept with no generally accepted definition. A person's sense of fairness will determine whether or not he/she finds the Tennessee tax system to be equitable. We do know that the Tennessee tax structure is regressive, and many have argued that this characteristic makes the system inequitable, since a regressive tax system is one in which the percentage of a family's income paid in taxes declines as family income rises. Tennessee's tax structure is regressive because of the emphasis on consumption-based taxes. It is an accepted fact that higher income earners consume a smaller portion of their income, so they pay relatively fewer taxes, compared to their income. Further, many items – including housing and most professional services – are not taxed by the sales tax. Such items are a larger part of the budgets of high income earners, providing a second reason why their taxes are lower relative to income.

Equity is a concept which is most commonly applied to personal taxes. Since businesses do not actually pay taxes, but shift them to consumers, owners, or workers, consumer equity should be examined by looking at

business taxes after shifting. The major concern for business taxes is that they not be capricious or discriminatory. If equity involves the lack of capriciousness and discrimination, taxes must be imposed so that the tax burden is even across industries. An equitable business tax burden will prevent the tax structure from encouraging or discouraging development of any specific industry, a factor which economists call tax neutrality.

Unstable Revenue Growth

Tennessee's present tax structure results in unstable revenue growth. During an economic expansion, revenues will grow moderately, but more slowly than income. The taxes on alcohol, cigarettes, and gasoline are per volume, or quantity, rather than per dollar spent, meaning that these taxes do not increase with inflation. Even the "general" sales tax grows more slowly than income, because it fails to tax many items purchased primarily by persons with higher incomes. During economic recessions, the consumption of major durable goods like automobiles and furniture declines so rapidly that sales tax revenues grow even more slowly relative to income.

These relationships signify two problems. First, because tax revenue growth is slower than resident's income growth, legislators must continually raise tax rates in order to keep the level of the public sector (government) constant relative to the aggregate economy. This leveling process has required five major tax increases in the past 14 years.

The second problem is that since, during recessions, the growth of revenue is much slower than the growth of income, the general decline in revenues relative to income becomes more obvious. The result has been that the pressures for tax rate increases have always accelerated during recessions; and, in fact, each of the five major rate increases has occurred at the end of a recession.

FIGURE 4

PERCENTAGE DISTRIBUTION OF STATE GOVERNMENT TAX COLLECTIONS TENNESSEE AND UNITED STATES, 1983

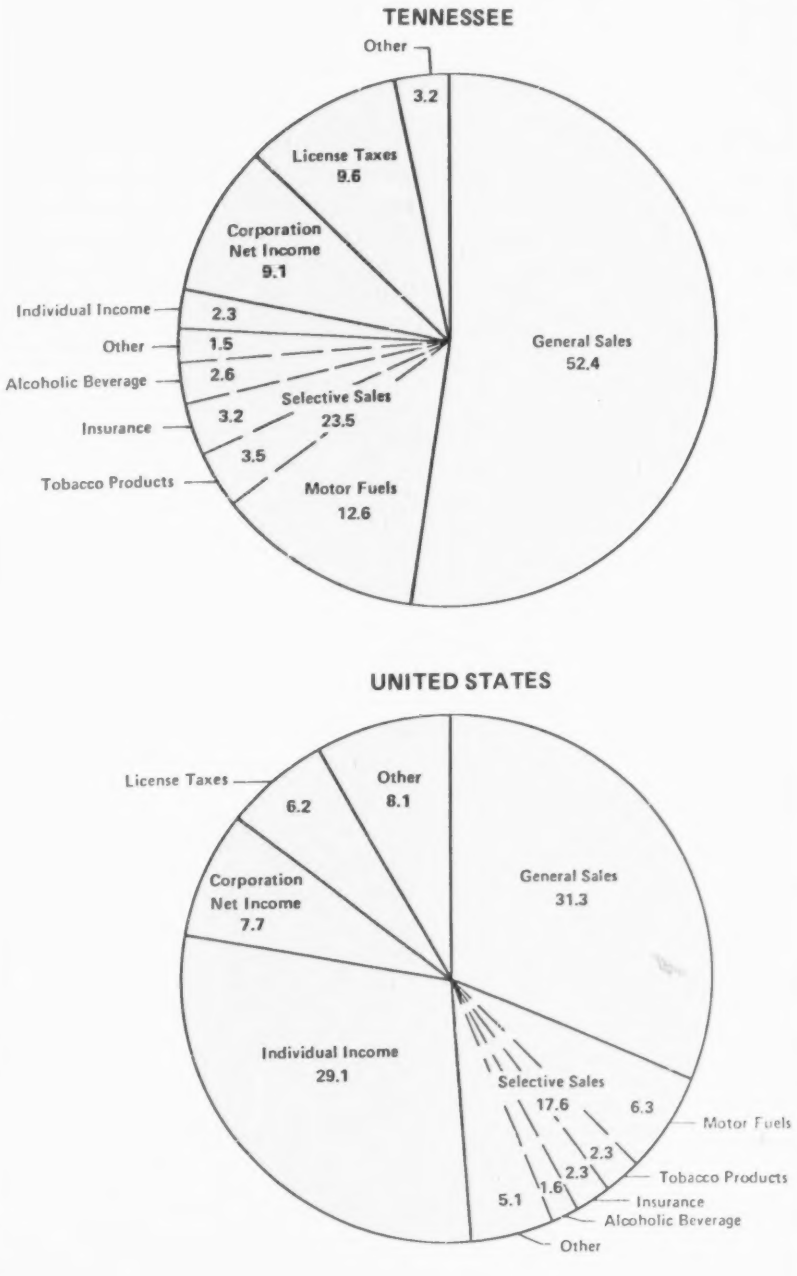
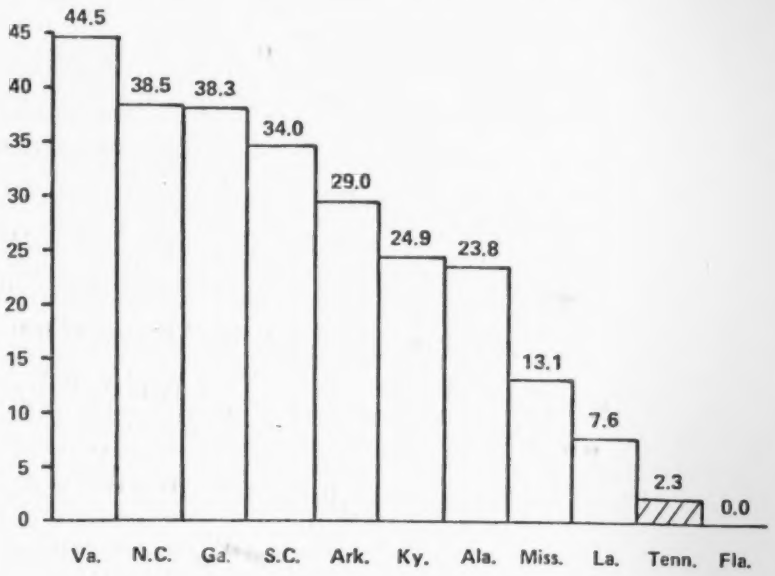
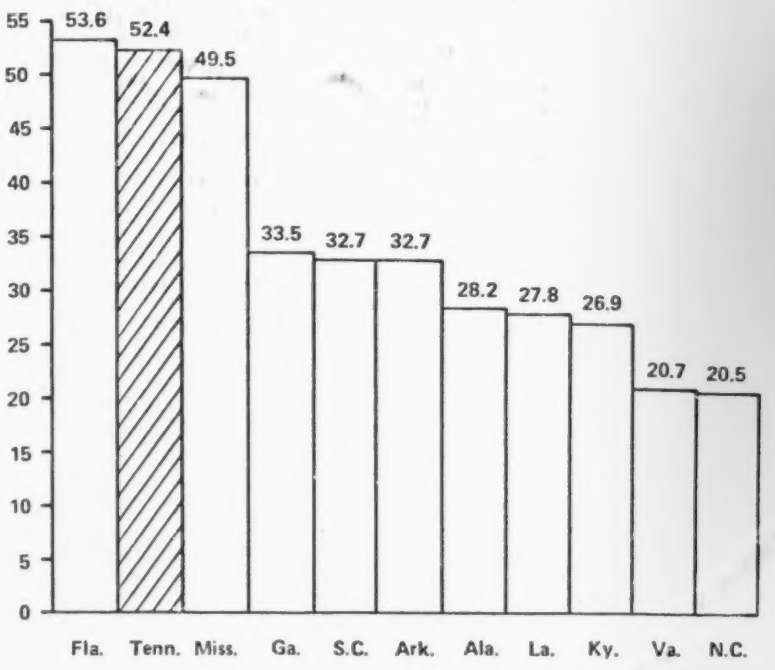


FIGURE 5

INDIVIDUAL INCOME TAX COLLECTIONS AS A PERCENT OF TOTAL TAX COLLECTIONS, SOUTHEASTERN STATES, 1983



GENERAL SALES TAX COLLECTIONS AS A PERCENT OF TOTAL TAX COLLECTIONS, SOUTHEASTERN STATES, 1983



Economic Development

Tax reform may be designed to make the Tennessee tax structure more competitive with surrounding states in order to attract business and minimize the effects of tax differentials along the borders. An important issue in firm location decisions is the business climate, which incorporates such factors as taxes, unionization, and willingness of government to cooperate with business. Tax savings themselves are a marginal factor in business location decisions, but it is desirable for the state's structure to be generally in line with those surrounding states which offer alternative sites for business firms. Corporate leaders realize taxes are necessary for providing services like education, police protection, and fire protection. They will find reasonable taxes acceptable, if they obtain an adequate return in services.

Tennessee taxes consumption more heavily than any of its border states, and each of these other states has a general income tax. High consumption taxes encourage Tennesseans living along the state borders to make their purchases outside Tennessee. Although tax differences have the greatest influence on cigarette, alcohol, and furniture purchases, they also affect other decisions. On the other hand, producers of nonretail goods and services may find it desirable to locate and work in Tennessee to avoid general state income taxes. One way to minimize these "border" affects is to avoid having a tax structure which is radically different from border states.

Raise Revenues

Those who regard the Tennessee public sector as too small would point to statistics given in earlier sections of this paper to support their contention. They might see tax reform as a way to raise revenues and therefore increase the size of government. However, neither of the committees studying taxes is doing so with the intent of raising additional revenues immediately. Both are looking at reform as restructuring the tax system by eliminating some sources and

replacing them with others. Members of the committees who see tax reform as necessary generally support some or all of the previously stated four reasons as justification for restructuring.

Reform must necessarily lead to replacement of revenues which will be lost through enactment of last year's legislation which exempts food purchases from the sales tax. No legislation provided for replacement funds or, alternatively, expenditure reductions. Financing state government and new programs such as the Master Teacher Plan is not possible unless the revenue is replaced.

Restructuring aimed at the problem of inadequate revenue growth need not generate new tax dollars immediately, but it can be expected to cause greater growth in revenues over time, so more revenues would be available in the future than are available under the current tax structure. Greater natural growth in revenues will enable the legislature to enact tax rate increases less frequently. Revenues can be expected to grow more slowly than income under any conceivable plan for restructuring Tennessee taxes. Therefore, the government sector will occupy a declining share of the economy in the absence of tax rate increases. Some rate increases may still be necessary in the future if the citizens desire state government to remain approximately constant as a share of the state's economy.

ALTERNATIVES FOR TAX REFORM

Four general bases are available for taxation: income, consumption, wealth, and business production (see Table 1). Each levy used today is seeking to tax one of these bases; thus restructuring will still involve taxing one, several, or all of these bases. The difference would be that the relative use of these four bases would be altered. Determination of priorities in tax reform will decide what changes are necessary in the way each of the bases is taxed.

Numerous alternatives could be considered for changing the tax structure or introducing new taxes, but most of these (for example, a lottery) would fail to represent substantive reform. There appear to be at least two, and possibly three, alternatives which are sufficiently large to constitute real reform: a flat business tax, a general state income tax, and expansion of the sales tax base.

Flat Business Tax

The first option can be termed a flat business tax (FBT). Under the FBT each business firm would be taxed at a low uniform rate based on its contribution to the state's economic activity. The tax would be levied on all business firms without regard to the type of industrial activity or legal organization. The base would include all income generated, or production originating, in the state. It could be computed either as the sum of payments in the form of dividends, interest, payrolls profits, and rents, or as gross business receipts less purchase for resale or inclusion in manufacturing for sale.

While the tax may be confused with a general sales tax, it is not because it taxes the value of goods and services produced in the state regardless of where they are consumed, and it fails to tax consumption of goods produced outside the state. At the state level, it closely resembles a proportional income tax levied at the point of origin. That is, it taxes all income generated in the state, no matter where the recipient lives. This includes wages earned by non-Tennesseans who work in Tennessee as well as profits, interest, and rents paid to non-Tennesseans, but generated in Tennessee. It is most accurately described as a tax based on economic activity – a price paid for government services. Government becomes an active partner in the production process, providing productive public resources to each firm at a uniform price. The tax is levied at the point where the economic activity occurs.

The FBT would produce large amounts of revenue at low rates, first because the base includes all production originating in the state, and secondly, because all firms operating in the state are subject to the tax. The rate for such a tax would probably be between 1 and 2 percent.

While the FBT can be used as a replacement for less desirable levies, it is inevitable that some shifts in the distribution of tax burdens would occur. The direction and extent of redistribution depends on the level of the FBT and the particular taxes replaced. Many are recommending the tax as a replacement for other business taxes, including the corporate excise,

TABLE 1

BASES FOR TAXATION

State Economic Bases	are taxed through	Selected Potential State and Local Tax Vehicles
Income		**Payroll Tax, Income Tax, Hall Income Tax**
Consumption		**General Sales Tax, Gross Receipts Taxes, Selective Sales Taxes**
Wealth		**Real Property Tax, Personal Property Tax, Inheritance Tax, Gift Tax**
Production		**Flat Business Tax**

Under the flat business tax (FBT) each business firm would be taxed at a low uniform rate based on its contribution to the state's economic activity. The base would include all income generated or production originating in the state.

corporate franchise, gross receipts, and local personal property taxes. Other taxes could be replaced as well.

Advantages other than high productivity often claimed for the FBT are increased equity, neutrality, simplicity, and stability. The tax measures the cost of public services provided to individual firms more accurately than do the traditional sales and income taxes, and therefore it is equitable in that business firms pay for the services they utilize. The tax reduces discrimination among industries and firms with regard to production and production processes (improved neutrality). Administration and compliance costs are minimized because fewer accounting records are required, or they are already available (greater simplicity). Tax stability is improved because of the broad coverage.

General Income Tax

The general income tax is a reform often suggested for Tennessee. This tax is offered as one way to reform personal taxes, while the FBT is an approach to business tax reform. Thus, the two should not necessarily be regarded as mutually exclusive.

A wide variety of different tax rates and bases can be chosen for an income tax. An attractive possibility is to use federal adjusted gross income as the definition (base) of income for state income tax purposes. This definition eases both compliance and administration of the tax but would incorporate current federal exclusions from the gross base. As few deductions and exemptions as possible could be allowed, so that taxable income is relatively large and the tax rate can be kept low. A flat rate between 2 and 3 percent would generate enough revenue to allow the state sales tax rate to be lowered and to permit elimination of the Hall income and local personal property taxes. One difficulty with using the federal income definition is that it adopts many of the inequities in the federal system.

A general state income tax would be advantageous because it would add stability to the tax structure, as income taxes are more stable than sales taxes. An income tax would add some administrative and compliance burdens, but if it is a replacement for the Hall income and personal property taxes, the additional burden would be modest. Internal Revenue Service auditing activities could be relied upon to minimize Tennessee administrative efforts. Those who feel the Tennessee tax structure is too regressive would see an income tax as desirable because the degree of regressivity would be lessened. Nonetheless, the tax structure would remain regressive if a low-rate, proportional income tax were introduced.

Broaden the Sales Tax Base

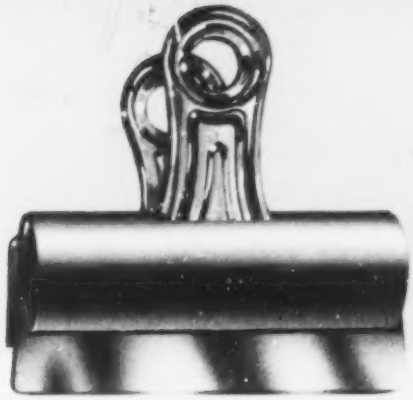
The sales tax base could also be broadened to include many categories of consumption which are not currently taxed. Candidates include legal, medical, and dental services and other currently exempt business and professional services.

Broadening of the base to include all consumption would increase sales tax stability, because overall consumption does not vary as much across the business cycle as do sales which are currently taxable. This would allow state government to have a more reliable tax source. A broader base would also be less regressive, because those categories of sales which are not currently taxable tend to be ones which are purchased most heavily by higher income individuals. The sales tax would remain regressive because higher income people have a propensity to save more.

The problem with this approach to reform is that insufficient revenues are involved to allow major changes in the tax structure. It is unlikely that the base could be broadened enough to allow even a 1 percent reduction in the state sales tax rate.

CONCLUSION

In conclusion, all evidence points to the need for a dramatic state-local tax reform in Tennessee. State-local taxes are relatively low, but they are inelastic and regressive. Business taxes are highly nonneutral. Because large sums of money are needed to do a respectable job of reform, only two viable sources of revenue are available – a comprehensive flat rate business tax, and a broad-based personal income tax. A third potential source, broadening the general sales tax base, is a less productive alternative. While a broader-base sales tax would recover revenues lost through exempting food from the sales tax base, it would not be sufficient for a general tax reform as deemed in the best interest of the state. ■



TAX REFORM: GOOD BUSINESS FOR TENNESSEE

The Honorable John T. Bragg and W. Jeff Reynolds

Tennessee taxes most people, most businesses, and most activities. But it does so through a system that lacks any rational design. State tax policy has evolved piecemeal over many years, and as a consequence the parts of the system do not always work together. In fact, some parts of the system actually work counter to each other. The end result is a system that serves no one well.

Historically, when additional revenue has been needed to maintain existing programs or to create new programs, the state has raised taxes. In certain instances, it has changed the bases of existing taxes or added entirely new taxes. In all these cases, there has been, no doubt, an attempt at fairness. But the primary concern has been to generate additional revenue.

If only a small amount of revenue is needed, the state has in some instances added "small" taxes. These small taxes cannot generate significant revenue because the base against which the tax is imposed is limited. In 1983, for example, there was a need for $4 million in additional revenue. A tax on coin-operated amusement devices was imposed. This base could never generate large revenues without being confiscatory.

Then, in 1984, there was a need for significant additional revenue to finance the "Better Schools" program. Significant revenue can come only from a large base; in this case, it came from increasing the sales tax rate.

These two recent examples illustrate the history of our tax system. We have seen a great many little changes intended to provide frequent small increases in revenues, and we have seen occasional large changes to provide large increases in revenues. It is rare to see a major change in the tax system that is not an attempt to increase revenues — *but that is what tax reform is.*

The Problem

During the early work of the Special Joint Legislative Task Force, both at its own meetings and at a statewide series of public hearings, three conclusions became clear:

1. The system is not fair to individuals
2. The system is not good for business
3. The system does not work well for government

Why has Tennessee's low tax rate not generated more business activity for the state? Perhaps it is the nature of the state's taxes rather than their level, which discourages business activity.

Each of these complaints warrants further explanation.

The Issue of Fairness

Consumption taxes, especially the sales tax, form the basis for the state tax system. In total, consumption taxes comprise nearly 75 percent of total state tax revenue. In fiscal year 1984-85, about 60 percent of state tax revenue will come from the sales tax alone.

At first glance, a sales tax would seem to be a fair tax. All people buy things and must therefore pay the tax. A sales tax appears simple because it applies to a basic activity: consumption. However, in practice, the sales tax is neither as fair nor as simple as it seems.

Because Tennessee's sales tax applies currently to basic goods such as food and clothing, the tax is regressive. Persons with lower incomes pay a larger share for these kinds of purchases than do those with higher incomes. Therefore, lower income persons pay proportionately more for sales taxes.

Many kinds of transactions are not subject to the sales tax. Purchases of medical services, legal services, and other professional services are among the items exempt. Some buyers are exempt regardless of what they purchase. Some products are exempt regardless of who buys them. Some goods or services are exempt under certain conditions or to certain buyers, and some sales are taxed at differing rates, depending on the intended use.

These exemptions and special treatments were probably enacted over the years in efforts to "be fair." Whether fairness has been achieved is debatable. What has resulted is complexity, confusion and a conviction on the part of many taxpayers that others are not paying what is fair.

Noneconomic Business Taxes

Some people contend that tax policy plays an important role in business decisions – especially those decisions about business location and/or expansion. Much of the evidence seems contrary to that contention.

Tennessee taxes are relatively low, as are the taxes of other states in the Southeast. It would seem natural, therefore, that such a factor would be attractive to businesses seeking new locations. However, Tennessee is 17th in personal income in the nation but only 44th in retail sales; Kentucky is 23rd in personal income but 32nd in sales. Why has Tennessee's low tax rate not generated more business activity for the state? Perhaps it is the nature of the state's taxes, rather than their level, which discourages business activity. The following two examples will illustrate this point.

Part of the concern of the Task Force has been with "tax leakage." Simply put, tax leakage is the loss of tax revenues to adjacent states with lower tax rates. A study made by The University of Tennessee Center for Business and Economic Research to study tax leakage in the border areas of Clarksville, Chattanooga, the Tri-Cities area, and the rural areas along the Tennessee-Kentucky border produced some interesting findings.

Results from the Clarksville study were the most dramatic. According to that study, Montgomery County (Clarksville) will probably lose $18 million in retail sales this year because of the 1 percent addition to the Tennessee sales tax rate that was passed in 1984. This revenue loss could result in a near 4 percent drop in the area's retail employment because people go to the bordering states to shop in order to avoid paying the tax.

For Tennessee, these results mean that the state will not receive as much increased revenue as hoped. Specifically, revenue will increase by one million dollars less than projections had indicated.

For Montgomery County the effect is more serious. The local sales tax rate was not changed, and the effect of the loss of retail sales is a loss of local revenues. For Montgomery County the problem is not a smaller-than-expected increase; the problem is that there will be a real loss of local revenue (perhaps as much as $400,000). That loss might mean a property tax increase.

The projected losses for Hamilton County (Chattanooga) and for the Tri-Cities area are not as large, perhaps due to some countervailing trends attracting retail sales. But the results confirm the same general pattern. Tennessee is losing retail activity, jobs, and state and local revenues to adjacent

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W. Jeff Reynolds has served three years as staff assistant comptroller of the Treasury, acting as principal staff assistant to the Legislature's two-year study of state and local taxes.

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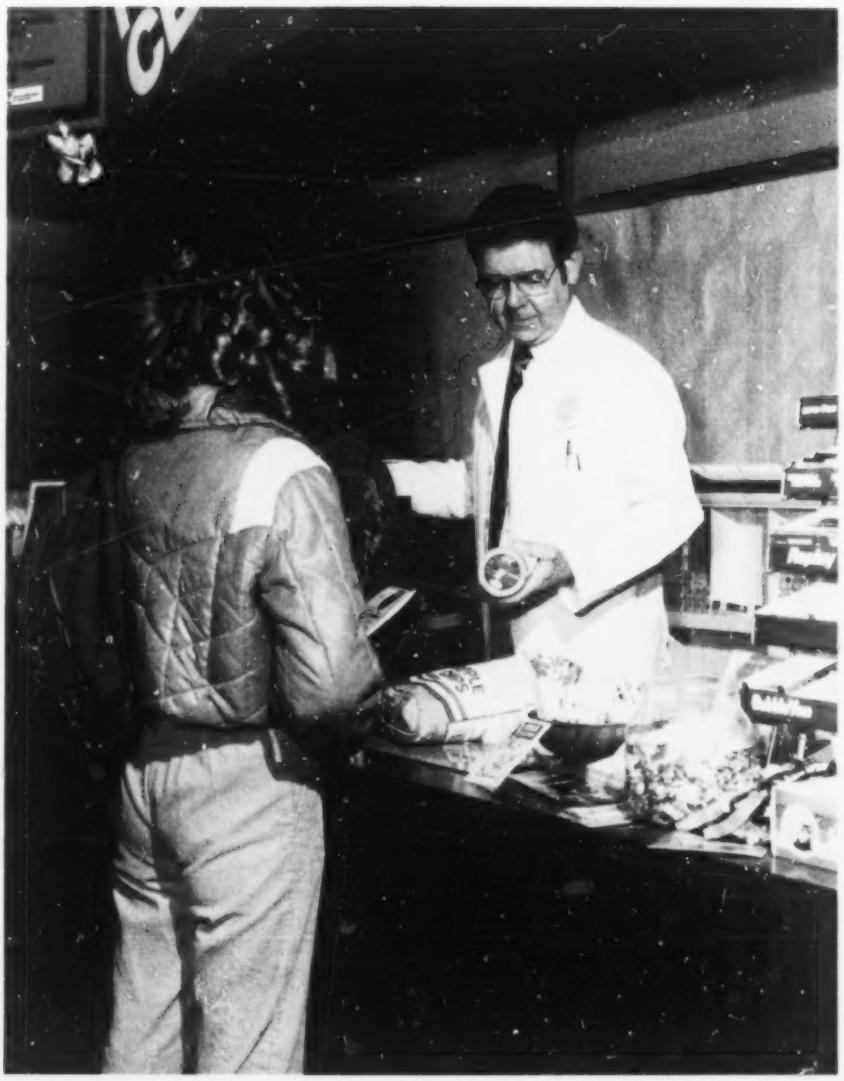


A Knoxville store owner totals up a customer's purchases before adding on state and local sales taxes. Consumption taxes, especially the sales tax, comprise nearly 75 percent of state revenue.

states because of the high sales tax rates. Therefore, property owners in the border counties indirectly may bear an extra burden in the state's effort to fund its educational improvement program.

A second area of major concern is business property taxes. The state constitution allows business real property to be assessed at a greater percentage of value than residential or agricultural property (40 percent rather than 25 percent). Further, the personal property of businesses is revalued annually, maintained at full market value, and assessed at 30 percent. Farm or residential personal property is, for all practical purposes, excluded from property taxation. Also, there is considerable variability among counties in how, and how well, business personal property is valued. The result is a relatively greater property tax burden for businesses – considerably more confusion.

The lesson learned from the two preceding examples should be self evident: tax reform would be good for business; tax reform would be good business for Tennessee.

The structure of taxes should be based on wealth, consumption, and on income. All who participate in society should contribute.

Performance

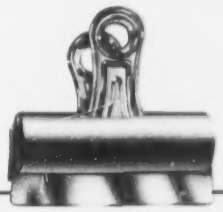
Under the current tax structure, tax increases are inevitable – not for new or expanded programs, but just to keep up. The state's tax structure is inelastic: that is, it does not grow as fast as the economy. Perhaps more important, the structure performs worst during periods of recession. Thus, under good economic conditions, revenues do not keep up; under bad times, they fall even further behind.

The problem arises because of a heavy dependence on the sales tax and other consumption taxes. As mentioned previously, the sales tax does not apply to all transactions, among them, certain services.

Thus, as the state moves from a "goods" economy to a "services" economy, the sales tax base comprises a smaller share of total spending. When the economy is growing, there is growth in the demand for government services (roads, schools, water supply, etc.). Revenues do not grow as fast.

In order for government to maintain a constant level of services, tax rates must rise. In 1983, the state's 4.5 percent sales tax generated the same amount of revenue (as a percent of personal income) as the sales tax in 1970 when the rate was 3 percent! The two sales tax rate increases (for fiscal years 1972 and 1977) kept revenues in line only with economic growth.

An even more confounding problem is the way tax revenues react to the economic cycle. When people are buying cars, appliances, and other durable goods, revenues are strong. When the economy slows, and buying slows, our revenues fall below budget estimates. During economic recessions, some demands on government services increase (for example, unemployment compensation, AFDC, and health services). And it is during these times that revenues are at their lowest.



SOLUTIONS

1. **Lower some tax rates.**
2. **Broaden existing tax rates.**
3. **Tax all appropriate tax bases.**
4. **Reduce the number of taxes and simplify the tax system.**

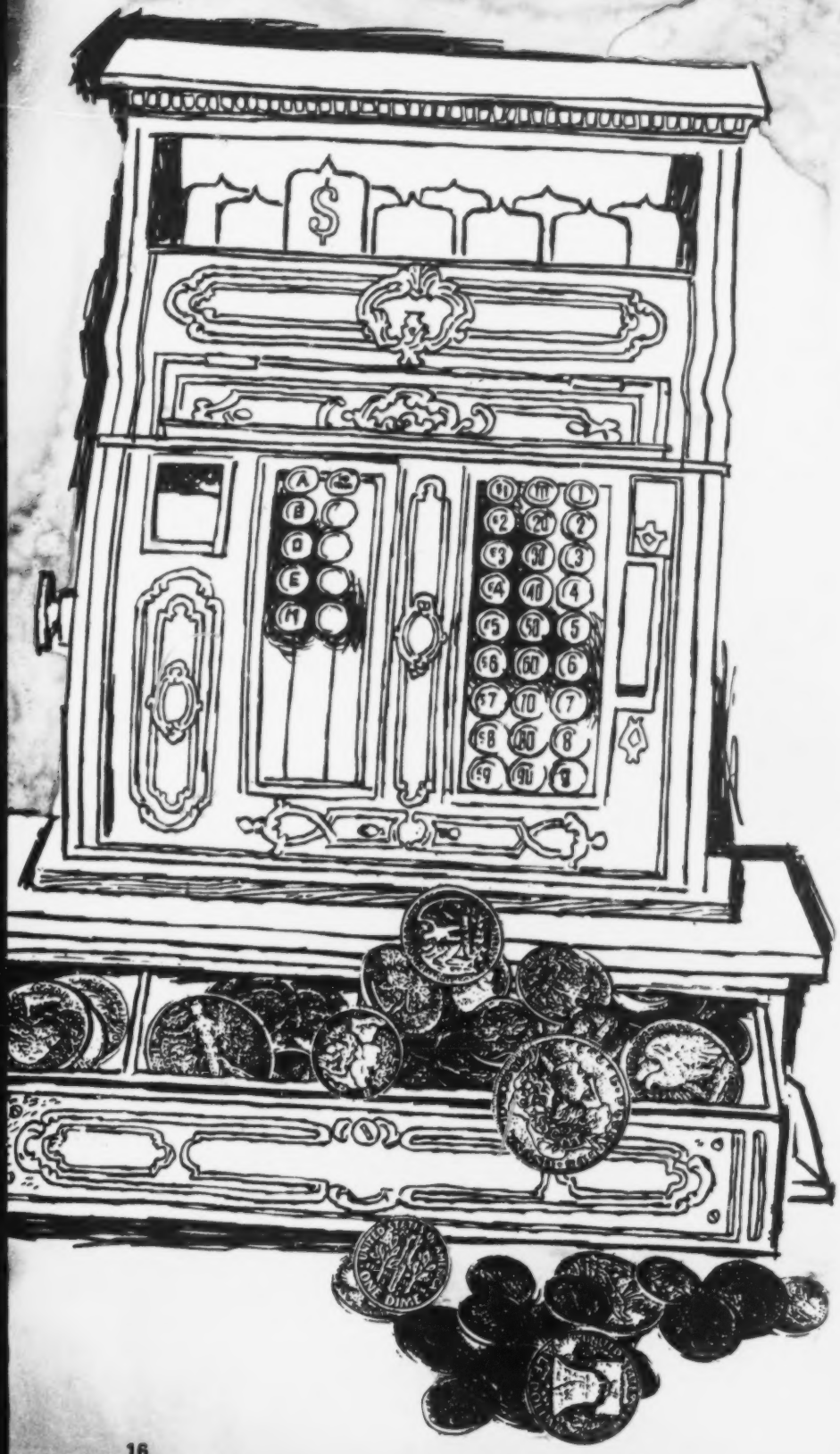
Solutions

The basic problems with Tennessee's tax structure are rather easily identified. The solutions will be harder to find. Here, nevertheless, are a few results that tax reform should direct itself toward:

1. **Lower some tax rates.** The sales tax is too high, especially as it is applied to basic necessities.
2. **Broaden existing tax bases.** The sales tax could be applied more broadly to achieve a reduction in rate.
3. **Tax all appropriate tax bases.** The structure of taxes should be based on wealth, consumption, and on income. All who participate in society should contribute to government. Those who benefit more should contribute more, if able to pay.
4. **Reduce the number of taxes and simplify the tax system.** The state taxes individual spending, ownership of property, and certain kinds of income. This is done through 14 different taxes and numerous other charges and fees. Tennessee taxes businesses based on their incomes, their profits, their worth, the value of their property, and their spending. Collections are made through at least seven taxes and numerous fees and charges. If the state wishes to discourage certain activities, they are taxed in order to make them more costly. Most taxes, however, are simply to generate revenue for government. The state should tax as simply as possible to achieve that end.

Some of these results can be accomplished by rather straightforward adjustments to the current structure: by eliminating exemptions, for example. Others might require major restructuring of the system – a personal income tax, for example.

Regardless of the difficulty in achieving reform, it must be done. The system should be fair, it should be simple, and it should perform well to benefit the state. The specific solutions will require the best efforts of elected officials and the support of the taxpayers of Tennessee. It is time for tax reform in Tennessee. ■



TAX ISSUES AND ALTERNATIVES

Stanley M. Chervin

Much of the debate on Tennessee's current tax structure centers on two problems: (1) state taxes paid by Tennessee residents are raised from predominately regressive tax sources; and (2) the business tax burden is not equally shared by all businesses.

Consumption Taxes

A major share of our state taxes is derived from, or based on, household consumption expenditures. Consumption taxes include not only the sales and use tax, but also selective state sales taxes imposed on gasoline, diesel fuel, cigarettes, beer, liquor, wine, mixed drinks, and insurance premiums. Figure 1 reflects both the dependence of Tennessee on consumption taxes (almost 76 percent of total state revenue in fiscal year 1983) and the level of similar dependence in other states. Such dependence is equaled or exceeded only by Florida, Nevada, South Dakota and Washington, all of which, by coincidence, have no broad-based personal income tax. Although the multiple tax rate and base changes passed during the last legislative session will leave the tax structure's dependence on combined sales and selective sales taxes at about the same level as in fiscal year 1983, the proportion accounted for by the sales tax will increase from 52 percent to 56 percent.

The major criticism of our state tax structure (as well as the local tax structure) is that it relies heavily on sales and selective sales taxes, almost all of which can be categorized as regressive. Since lower income families

spend a higher proportion of their income on taxed goods and services than upper income families, they pay *relatively* more in taxes, but only in relation to their income. They do *not* pay more than upper income families in sales taxes and they do *not* pay most of the sales tax paid on food. The fact that they pay *relatively* more in taxes may be reason enough to criticize the sales tax and work to effect changes in it; however, misstatements do little to advance rational debate.

Business Taxes

State business taxes generally refer to the corporate franchise and excise taxes and the several gross receipts taxes which are imposed on a small list of business activities, although they are not a general tax on all businesses. Businesses in Tennessee pay other state taxes, although these taxes are not generally categorized or recognized as "business taxes." They do deserve mention since the amounts involved are substantial.

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Sales and Use Tax. This tax applies to final purchases made by businesses as well as those made by individuals. The tax is levied on business purchases of office equipment and supplies, telephone services, and energy purchases (the sales tax rate on energy sales to commercial establishments is 5.5 percent rather than the 1.5 percent which applies on sales to households and manufacturers). The data reported to the Department of Revenue do not include sufficient detail to make a firm estimate of the business sector's portion of total sales tax collections. However, based on information from other states and studies about sales taxes paid by Tennessee businesses, a range of 15 percent to 25 percent appears reasonable. Such a range implies that businesses will pay between $254 million and $424 million in state sales taxes in fiscal year 1984-85. The sales tax, therefore, is as much or more a business tax in Tennessee than the corporate excise tax (corporate income tax).

Other Business Taxes

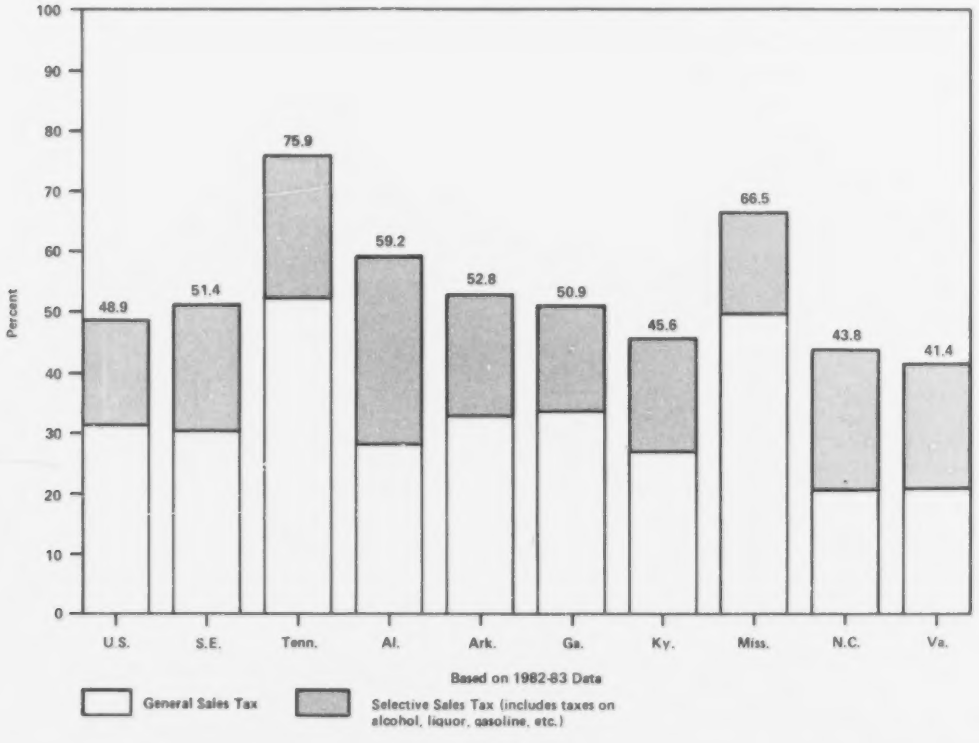
In addition to the sales and use tax, Tennessee businesses also pay a portion of other major consumption taxes. These other taxes and estimates of the business portion are as follows: Gasoline Tax, 20 percent; Special Petroleum Products Tax, 30 percent; Motor Vehicle Fuel Tax (diesel fuel), 90 percent; and Motor Vehicle Registration Fees, 40 percent.

Business Tax Considerations

Although some are debatable, certain general statements can be made regarding state taxation of business activity:

FIGURE 1

DISTRIBUTION OF STATE TAX REVENUE
SOUTHEAST STATES, THE REGION, AND US



- Classifying taxes on the basis of their initial tax incidence (on a business or on an individual) is a questionable exercise.
- The proportion of total state taxes paid directly by businesses in Tennessee appears to be in line with other southeastern states. The tax rates on the major state business taxes are generally in line with other states, although both the franchise tax and the sales tax are relatively high.
- The most glaring inequity in business taxation in Tennessee is the absence of state taxes on unincorporated businesses and the current gross receipts taxation of a small select list of business activities (bottling, telephone services, and private electric and gas distribution).
- While "business taxes" do have a certain political appeal because they appear, at first instance, to fall on an enterprise rather than on an individual, the eventual impact is to reduce the real income of some individual or individuals. In some cases, the impact will be on business owners; in others, on employees; in others, on customers; and in most cases, some combination of all three.
- The most important question regarding business taxation may be simply to insure neutral tax treatment of businesses within a state and comparable rates of business taxes vis-a-vis other neighboring states.

The Alternatives

The question of whether or not the tax structure needs a serious overhaul at this time remains very much a political issue. However, the number of viable alternatives to the existing tax structure is limited.

The following list includes taxes which are currently not utilized in Tennessee, or which are substantially underutilized, *and* which promise a potential of $50 million or more per year. Estimates refer to fiscal year 1985-86 (income tax estimates refer to calendar year tax liability). Major pros and cons for each category are included.

Broad-Based Personal Income Tax

A flat rate tax of 1 percent (with $1,000 exemptions) will generate $340 million, while a slightly progressive tax of 1, 1.5, or 2 percent will generate $500 million. Passage of a broad-based income tax should be accompanied by the repeal of the current Hall Income Tax (loss of $50 – $60 million). Forty states currently utilize a broad-based income tax in their tax structure.

- *PRO* – Capable of being used to effect a major change in the tax structure by reducing the state's dependence on sales and selective sales taxes.
- *CON* – The tax would probably be subject to a legal challenge, regardless of existing opinions that it is constitutional. The biggest obstacle still appears to be a lack of widespread public support for the concept.

Further Broadening of the Sales Tax Base to Include All Services (Not Now Taxed)

While the sales tax base was broadened in June 1984 to include amusement and recreational services, many services remain exempt. The potential from these remaining exempt services at a 5.5 percent rate is $224 million (for the state) and $81 million for local governments (at an average 2 percent rate).

- *PRO* – Broadening of sales tax base to include more services will increase the elasticity of the overall sales tax (with respect to growth in personal income) and make the sales tax slightly less regressive.
- *CON* – Political likelihood of subjecting services of physicians, dentists, lawyers, plumbers, carpenters, etc. to the sales tax is unknown (physicians account for almost 50 percent of the potential from this source). Note also that the cost of these services would increase because of the addition of the sales tax (in addition to whatever rate of inflation might be occurring).

Broaden Sales Tax to Include Gasoline and Diesel Fuel Sales

The potential from a 5.5 percent state sales tax on gasoline is $147 million. The local tax potential, at a 2 percent rate, is $54 million. The potential from a 5.5 percent state sales tax on diesel fuel is $30 million, while the local tax potential (on diesel) at a 2 percent rate is $11 million. While most states which utilize a sales tax exclude motor fuel sales from the tax base, the number of such sales has risen to eleven. The traditional opposition of highway users and road builders has slowly been countered by the need for additional revenue and the absence of any logical reason for its exclusion from a general sales tax.

- *PRO* – There is no economically valid reason for the current exemption of gasoline. Traditionally fuel has been considered a target for excise taxes which are earmarked for highway use, but the same logic has not been applied to other items subject to selective sales taxes (e.g., tobacco, liquor, wine, and beer are all subject to the sales tax).
- *CON* – Traditional opposition from special interest groups such as road contractors and truckers (in the case of diesel).

Broaden Sales Tax to Include the Lease or Rental of Real Property

The revenue potential per 1 percent rate is $12 – $14.5 million ($66 – $80 million at a 5.5 percent state rate and $24 – $29 million at an average 2 percent local rate).

- *PRO* – Substantial revenue from what will likely appear to be a tax on businesses (rather than individuals).
- *CON* – Not commonly included in a sales tax (only two states currently tax real property leases). While the tax may appear to be primarily borne by business, it will probably be pyramided into the final prices charged by affected businesses on their final sales to the public.

Impose a State Property Tax

The estimated value of all taxable property in Tennessee was $91 billion in 1982. The value for 1985 is estimated to be $98 billion. Assuming an average assessment ratio of 20 percent, the 1985 estimated assessed value of property would be approximately $20 billion. A state property tax rate of 10¢ per $100 of assessed value would raise $20 million.

- *PRO* – A relatively low tax rate could raise a substantial amount of money, and state administration of a property tax program might improve the overall consistency and uniformity of real and tangible property appraisal.
- *CON* – Local government would probably oppose an attempt by the state to use a tax which local governments consider to be their "tax." Surveys show that taxpayers consider this tax one of the worst.

Substitute a Single-Business Tax for Existing Business Taxes

Repeal of the business taxes (excise, franchise, gross receipt taxes, the local business tax and the local personal property tax) would cost about $636 million (this figure reflects the recent increase in the franchise tax rate). The tax base for a single-business tax (essentially a state value-added tax) is estimated at $46.1 billion. The tax potential at 1 percent is $461 million. A 1.4 percent rate would be required to offset the revenue loss from the business taxes listed for repeal. The rate could be further adjusted to replace revenue lost from reductions in the sales tax (if that were included as part of a tax restructuring program).

- *PRO* – This tax has some interesting conceptual selling points as long as it is not perverted (as it partially was in Michigan). The tax would go a long way toward ending the existing discrimination that now exists against corporate businesses versus sole proprietor and partnership businesses. It insures that all businesses pay for governmental services just as they now pay for other economic resources used in their operations.
- *CON* – It *is* a value-added tax. It can be argued that it favors capital-intensive businesses in contrast to labor-intensive businesses (maybe this is a plus), and its very nature has been totally or partially misunderstood by many of its opponents.

Gross Receipts Tax on Utilities

The gross receipts tax on utilities is a 1 percent tax on the intrastate receipts of businesses involved in distributing, supplying, furnishing or selling electricity, gas, telephone or telegraph services, or water and sewerage services, regardless of whether they are private or public enterprises. This tax, with no credit for other taxes paid, would generate $55 million. Repealing existing gross receipts taxes imposed on some of these activities would cost $23 million, leaving a net increase (from a 1 percent tax rate) of $32 million. A 2 percent tax rate would raise $87 million and a 3 percent tax rate, $142 million.

- *PRO* – Similar existing taxes are now imposed only on telephone and telegraph companies and a few private gas and electric companies. This change would treat all utility enterprises the same. Business would pick up at least 50 percent of the cost.
- *CON* – This tax would raise gas and electric rates (in addition to already rising telephone rates), and local public utilities would probably place full blame for rate increases on the state.

Business and Occupation Gross Receipts Tax

Business and occupation gross receipts taxes tax the dollar value of all gross receipts from sales in Tennessee by manufacturers, wholesalers, retailers, mining, and service businesses. This tax would apply to Tennessee and non-Tennessee businesses with nexus in Tennessee. The estimated tax base is $75 – $100 billion. A 5 percent tax rate would generate $500 million (assuming no deductions, exclusions, etc.).

- *PRO* – Substantial revenue potential and a tax which is applicable to all businesses regardless of the form of organization.
- *CON* – Results in a pyramid tax (manufacturer's sales to a wholesaler are taxable, the wholesaler's sales to a retailer are taxable, and the retailer's sales to the public are taxable. A substantial administrative framework would be necessary.

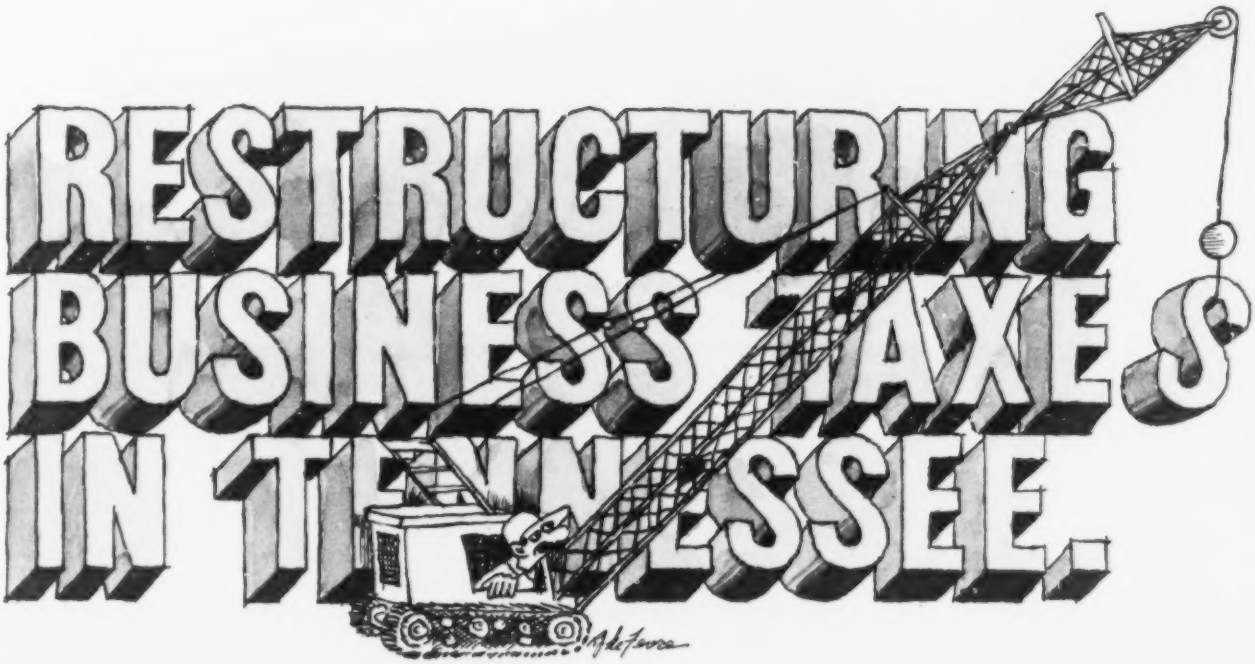
Analysis

The first logical step toward reform must be a very deliberate analysis of the existing tax structure to determine which current elements of the structure are excessively unfair to individuals and/or businesses, or simply failures as workable taxes. This step must precede consideration of alternatives, since even the alternatives have shortcomings. If certain taxes are identified as being unfair for any reason, then they are serious candidates for repeal or change. If such repeal or change will cause a significant revenue loss, the alternatives described all become potential replacements.

As replacements, they should not possess the shortcomings of the taxes being considered for repeal. This would be self-defeating. They must be true improvements or the exercise in reform will be an embarrassing failure. This does not mean that the recommended changes must be popular; if it is to be a popularity contest, the reform project at this stage would have trouble getting off the ground. The recommended changes, if any, will have to be explained to business, the public, and the press, and to be perceived as improvements before any chance of statutory change becomes possible.

In 1964, 74 percent of state tax revenue was raised from sales and selective sales taxes. The figure today is about the same. Despite the findings of several tax study committees during the last twenty years and despite many recommendations, Tennessee's state tax structure is substantially the same. Once the state decides it is ready to commit to change, alternatives are available. ■

RESTRUCTURING BUSINESS TAXES IN TENNESSEE.



Kenneth E. Quindry
and
John L. Parish

Increasingly in recent years, public finance specialists have recognized that the Tennessee state-local business tax system does not adequately serve our modern business community. Although Tennessee is supplied with an abundance of able workers and natural resources, it has not used them well, despite a seemingly responsible attitude toward economic development.

A primary reason for economic stagnation is that tax modernization has lagged tragically. The present tax structure assumed its basic form with the imposition of the general sales tax in 1947 and its extension to local governments in 1963. Not surprisingly, it has developed structural weaknesses over the two decades of rapid technological change. This is particularly true of business taxes. The legislature has regularly given its attention to encouraging economic growth through business tax incentives, but the outcome has been an overwhelming morass of credits, deductions, exemptions, and exclusions, adding to the already widespread complexities, misunderstandings, disappointments, and instances of tax evasion.

Business activity is a necessary and reasonable basis for taxation, but tax modernization has not advanced at the same rate as technological development in production. Consequently, business taxes inhibit the state's economic growth because they discriminate among methods and techniques of production and among products. Recent fragmentary modernization attempts have served only to divert attention and efforts from what is really needed – a comprehensive reform of business taxes. In this article, a restructuring plan is proposed that will effectively promote the potential for economic development by rationalizing and simplifying the business tax system.

The Goal of Tax Reform

The role of government in a society is to support business in its efforts to earn a reasonable return on its investments and the citizens in their efforts to earn a living and enjoy the benefits of their efforts. In order for government to operate as an effective partner in economic activity and growth, it must resort to taxation. Every effort must be made to encourage the growth of industries with the greatest potential to employ workers at adequate wages in the factories, mines, and shops. Proper taxation attracts business investment, the foundation of jobs, and income.

The ideal business tax system would require every firm operating in the state to pay a fair share of the costs of state and local governments in an economic and efficient way. This, precisely, is the goal of tax reform – to

establish a system in which every taxpayer shares equitably according to some accepted standard of fairness. For business, this standard is to assess each business in proportion to the costs of any public services it requires or is provided. In this respect, government becomes an active partner in the production process by providing public goods and services to all businesses at a uniform and reasonable price. The consequence of nondiscriminatory taxation is the balanced development of the state's productive resources – maximum employment and income.

Objectives in Tax Reform

To achieve the maximum impact on economic development, at least four objectives of tax policy must be accomplished.

The first objective is revenue *adequacy*. Revenues must always be sufficient to meet the current cost of government. State and local budgets must be balanced annually. Business taxes should be sufficient to meet the cost of public services provided to business. Family and individual taxes should be sufficient to meet the cost of public services provided to them. Business should not be required to subsidize personal public services, nor should personal taxes be required to subsidize public services to business.

Moreover, revenues must increase over time to meet expenditure needs as the economy grows and changes and taxpayers require different and better services. The economist calls this "elasticity." Many observers would consider elasticity adequate if business taxes expanded in step with business activity. With this unitary elasticity, taxes become neither a larger nor a smaller share of private business activity. Taxes grow at the same percentage rate as economic activity. Public service levels can be maintained without any legislated tax increases.

Closely akin to elasticity is the stability of tax yield within the business cycle. Tax revenues ebb and flow with the business cycle swings. Revenue swings may be more or less violent than swings in economic activity. That is, elasticity fluctuates over the business cycle. The violent short-run fluctuations in revenue (elasticity) inhibit the government in its efforts to provide a steady flow of public services.

The second objective is *equity*. Taxpayers are not likely to object to taxes if they believe they are treated equal to other taxpayers in equal circumstances – according to some accepted standard of fairness. Possibly the most acceptable standard would be for each firm to pay only for the costs of public services it receives and for any other costs it might impose on government and the community in which it does business. Using this principle, government serves as an unbiased partner in business activity and growth. The critical problem is that of determining the proper standard for measuring individual firm consumption of public services.

The third objective is *economic efficiency*. Equity is a key element in economic efficiency. All firms and industries are equal and necessary in economic activity and growth and must be treated equally. Another key word is tax neutrality. The government should not permit tax policy to influence the direction of business investment or the use of productive resources. Neutrality permits business decisions to be made on an economic basis and leads to optimum employment of the state's workers and the use and development of capital and natural resources. By treating all productive resources, activities and processes equally, taxation reacts favorably on technological growth and worker productivity.

The fourth objective is *simplicity and economy*. In the pursuit of other worthy objectives, state and local governments have adopted several special taxes, tax credits, deductions, exclusions, and exemptions that have outlived any logical and useful purposes they might have had. All have served to complicate the tax system and cause excessive costs for both administrators and taxpayers. A simple and economic tax system would consist of a limited number of productive general taxes void of all unnecessary complexities. The taxpayer would be relieved of gathering and storing massive amounts of data and of filing numerous complex forms. Additionally, the government would not be required to receive, process, store, and audit such materials.

Many complexities in taxes arise because government attempts to utilize

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By treating all productive resources, activities, and processes equally, taxation reacts favorably on the technological growth and worker productivity.

taxes to solve either real or imagined moral or social ills, or to award or punish business or individuals. These utilizations serve only to complicate the tax system and confuse tax administrators and taxpayers. If these are considered to be legitimate government objectives, they can be better fulfilled by means other than taxation or relief from taxation.

The Reform Proposals

Table 1 illustrates a program for tax restructuring which consists of five parts.

The first part is to restore or add to the sales tax certain basic elements that contribute to improved equity, productivity, stability, elasticity, and simplicity. The greatest offender in this regard is the government's recent decision to remove food for home consumption from the tax base. Not only is productivity unduly reduced, but broad avenues for tax avoidance and evasion are opened up, and the cost of administration and compliance are increased. Food and services should be in the sales tax base.

The second part is the removal of several offending taxes or provisions of taxes, including those that are nonproductive, complex, inequitable, inimical to economic growth, and/or costly for administration and compliance. Among the worst offenders are the corporation excise (income) and franchise taxes (Tennessee Code Annotated, Chapter 29), the series of selective gross receipts taxes (Chapters 41 and 42), the local business gross receipts taxes (Chapter 58), all of Title 67, and the local business personal property taxes.

The third part of the program is to provide a replacement tax to recover revenues foregone in the second part. This tax would apply equally to all business and professional firms maintaining a tax nexus in the state. It would also utilize a common tax base easily accessible to all, primarily from data gathered for federal tax purposes or readily available from current accounting records.

Government costs are created by business activity. Consequently, the

TABLE 1

RESTRUCTURING PROPOSALS IN SUMMARY

I. General Sales Taxes
- **A. Terminate the current temporary one (1) percent rate**
- **B. Retain food for home consumption in the tax base**
- **C. Broaden the base to include:**
  1. **rental and lease of real property**
  2. **personal and business services not now covered**
  3. **vending machine sales**

II. Repeal the following taxes
- **A. The local business gross receipts taxes**
- **B. The Hall income tax**
- **C. The corporation franchise and excise taxes**
- **D. The local personal property tax**
- **E. Various privilege taxes**
- **F. The vending machine gross receipts taxes**

III. Enact a flat-rate, low-rate general business tax on all business and professional firms with a taxable situs in Tennessee

IV. Provide a state-to-local revenue sharing program to retain the current division of revenue between the state and its subdivisions

V. Provide a graduated rebate program to remove the "excess" burden of sales and residential property taxes on low-income individuals and homesteads

base most accurately reflecting tax responsibility would be measured by business activity. This base would measure total business gross sales (from federal tax forms), less cost of merchandise purchased for ingredients in manufactured articles for sale (raw materials in manufacturing and assembling), or merchandise purchased for resale (both from federal tax forms), times a ratio representing the portion of business activity in Tennessee (from current company records). Full 100 percent first-year write-off for investment and a reasonable exemption from taxation would be permitted to encourage investment and small firm startup. A low uniform rate would be applied to the tax base.

The fourth part is to construct a state-to-local revenue-sharing formula and allocate and distribute state tax funds to replace local revenues reduced by the program – most notably the local personal property taxes and the local business gross receipts taxes. In short, total government revenue reductions would be reimbursed by the state.

The fifth part is leveled at tax burdens on families and individuals. It recognizes the fact that restoring food to the sales tax base adds to an already income-regressive tax system. A rebate program for sales and residential property taxes would essentially provide for proportional tax burden on families and individuals.

The sales tax rebate portion would supplant the exemption of food from the sales tax base; and the residential property tax rebate program would supplant the current program limited to the very low-income aged and disabled *homeowners*. This proposal would serve *all* homesteads, including renters who could claim a substantial portion of their occupancy rent as an indirect property tax payment. This proposal is similar to the "circuit breaker" property tax relief program currently used in about three-fifths of the states. Rebates would be graduated according to income, so that only "excess" tax burdens would be relieved. The sales tax portion would be a graduated rebate (decreasing as household income increases) for every member of the household.

The regressivity of personal taxes is reduced . . . by broadening the sales tax base and by the sales and property tax rebate program.

This arrangement would improve tax adequacy. Tax productivity would be retained. The flat rate business tax (FBT) at a low rate would restore funds due to suggested revenue reductions. Tax elasticity would be mildly improved by shifting from consumption taxes to taxes based on economic activity. Tax stability would be improved by restoring and adding stable elements to the sales tax base and by removing taxes based on business profits.

This arrangement would improve tax equity. Business tax equity is improved by emphasizing a single nondiscriminatory tax based on public resources utilized and by removing several taxes discriminating among industries.

The regressivity of personal taxes is reduced, not by an expensive and complex sales tax exemption for food, but by broadening the sales tax base and by the sales and property tax rebate program. Tax complexities and potential avoidance and evasion are especially reduced by returning food to the sales tax base. The retention also restores productivity of the tax while regressivity is reduced by the relatively inexpensive rebate program. It is estimated that in lost revenue the rebate program would cost about 10 percent as much as that of a food tax exemption.

This arrangement would improve the economic efficiency of the tax structure. The proposals promote tax neutrality, allowing economic decisions to be made on the basis of economic decisions rather than on tax aspects. Investment and employment decisions would not be tied to decisions attempting to minimize the tax influence on rate of return.

Because investment would be treated as a current expense, new firms and firms expanding and modernizing rapidly would erase or minimize their tax liability during the years of growth. Because the first portion of sales would probably not be taxable, many small firms would be exempt. Tax filing is limited only to firms providing significant revenue.

This arrangement would simplify the tax structure. It removes several "nuisance" and low productivity taxes, and it simplifies other tax bases (e.g., the general sales tax base). The Flat Business Tax (FBT) is not only more economically efficient, but less complex for both administrators and taxpayers. Table 2 demonstrates the simplicity of an efficient flat rate business tax form.

Changes in Business Tax Burdens

The reform package is not designed to increase business tax burdens, but only to adjust tax burdens in the interests of equity, simplicity, and economic development. Burdens would be increased on some industries not now perceived as paying a fair share of taxes and reduced on others assumed to be paying excessively.

The burden distribution changes among business enterprises will depend on the extent of taxes paid under the provisions repealed and the liabilities under the new tax and tax provisions. Some firms will pay less, others more. Unincorporated businesses, which do not pay excise (income) and franchise taxes, will have limited relief. They may receive some tax relief, however, because personal property taxes, local

business gross receipts taxes, and other selective sales taxes will probably be eliminated. Such businesses would be subject to the new FBT. Unincorporated professional, service, and trade businesses are in this category.

Corporations not earning a profit or limited profits will get less relief than highly profitable corporations from removal of the excise (income) tax. All will get relief from the removal of the personal property and some other taxes. All will be subject to the FBT.

Professional corporations usually manage to limit excise tax liability and do not have significant purchases of merchandise for resale to deduct from gross receipts. They are not currently subject to the general sales taxes. Their relief may seem limited because their tax responsibilities are now limited. Imposition of the new tax provisions places them on an equal basis with all other business enterprises. (The assumption is that a professional firm, incorporated or not, is a business enterprise, engaged in selling a service and small amounts of goods the same as the commonly recognized service industries on Main Street, U.S.A. In serving them the government incurs costs for which they should pay equitably with other firms. The tax will be absorbed by the firm or shifted to consumers just as any other tax by any other firm.

In short, reasonable expectations are that, in general, the burden shift may be for lower taxes on manufacturing firms and higher taxes on trade and professional enterprises and possibly on the service industry. Incorporated enterprises (depending on profitability) can expect greater relief than unincorporated businesses which are not subject to excise (income) and franchise taxes.

TABLE 2

SUGGESTED BUSINESS TAX FORM

Firm Name _____

Address _____

Identification No. _____ **Principle Product** _____

1. Gross Business Revenue (Everywhere)	$_____
2. Costs (Everywhere)	$_____
a. Goods for resale	$_____
b. Raw materials in manufacturing	$_____
c. Services	$_____
d. Capital investment	$_____
e. Total (a + b + c + d)	$_____
3. Taxable Income (Everywhere) (line 1-less 2e)	$_____
4. Allocation to Tennessee (____% of line 3)	$_____
5. Tennessee Taxable Income (line 4 less $10,000*)	$_____
6. Tax Liability (Rate % x line 5)	$_____
7. Tax Carryforward from previous years	$_____
8. Tax due (line 6-less line 7)	$_____
9. Tax Carryforward (to future years)	$_____

***The allowable exemption from the tax base could be another amount, e.g., $20,000, $25,000.**

Analyses

The restructured tax system would encourage economic development, employment, and income when compared with the current tax system, because it is fair and simple. It would remove the current bias against investment, productivity, and technological development, because it removes the inequities and complexities ingrained in the current tax system and replaces them with an equitable simplified tax system.

The FBT is equitable for the following reasons:

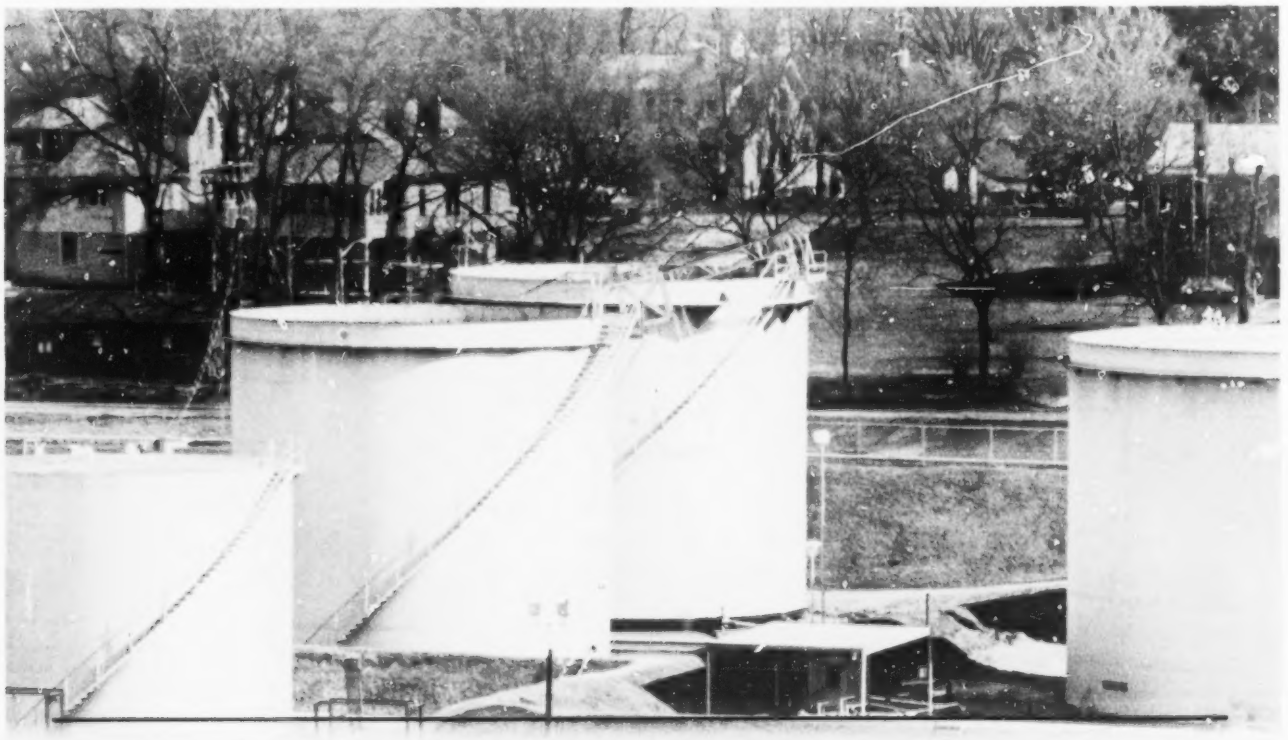
(a) It applies equitably and uniformly to all productive activity.
(b) It is levied at a uniform rate on all productive activity.
(c) It does not lend itself to extraneous uses of taxing power.
(d) It removes the opportunity for tax avoidance and evasion because the base is comprehensive and the

number of taxpayers is minimized.

(e) All business activity is taxed once and only once close to the source.

The FBT encourages new small firm development, equipment modernization, and technological growth by permitting immediate expensing (100 percent first-year write-off) of investment; removes the primary need for a personal income tax, since all economic activity (including labor compensation) is included in the base of the FBT; and improves tax elasticity and stability.

Finally, the suggested restructuring would reduce the overall cost and complexities of tax administration and compliance by concentrating the tax efforts in a few taxes that are simple, low-rate, broad-based, general, and productive. With restructuring, government tax administration bureaucracy would be reduced, and private resources engaged in tax compliance efforts would be put to productive uses. ■



THE FLAT BUSINESS TAX WOULD:

I. **Tax each firm on the basis of public services received according to its contribution to the state's economic production.**

II. **Tax all economic activity once and only once at a low rate. Eliminate double taxation.**

III. **Remove the opportunity for tax avoidance and evasion by limiting the number of taxpayers and concentrating the tax base in a single general tax.**

IV. **Tax all firms equitably on a standard base, promoting balanced economic growth – maximum employment and income.**

V. **Encourage new small firm development, modernizing of machinery and equipment, and technological change by permitting immediate expensing of investment.**

VI. **Remove the primary need for an income tax, since all personal economic activity would be taxed equitably at the source.**

VII. **Along with other reforms suggested, minimize the number of taxpayers and simplify the tax structure while maintaining the flow of state and local tax funds.**

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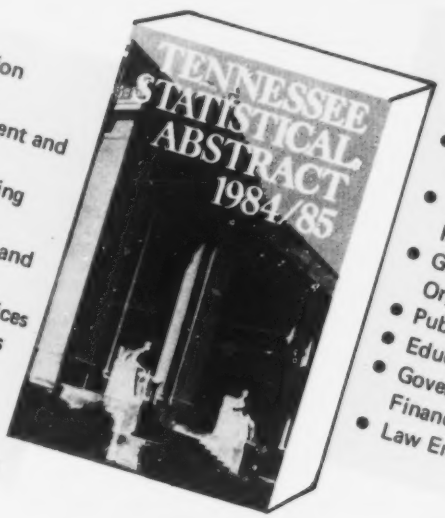

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